

Draft Interim Report- Treasury Bond Issue on 27.02.2015

Prepared on 25.06.2015 at 8.45 p.m.

On the 19th of May, 2015 Hon. Dinesh Gunawardena brought to the notice of the Committee on Parliamentary Business that a Motion signed by Hon. Prof. G.L. Peiris and several other Members of Parliament regarding the Governor of the Central Bank of Sri Lanka was submitted which was to be included in the Order Book of Parliament and a debate on this Motion be conducted as an important and urgent Motion. Thus the Motion was entered in the Order Book of Parliament 14(1) of 08.05.2015 as an undated Motion. It was the position of the Hon. Speaker that the Motion be submitted regarding the Governor of the Central Bank of Sri Lanka (CBSL) to the Committee on Public Enterprises (COPE) and allow it to be appropriately investigated by a Sub Committee appointed by the Chairman of the Committee and that arrangements must be made for a report to be submitted to Parliament in this regard within two weeks.

Accordingly, a special meeting of the Committee on Public Enterprises (COPE) has been held on 22nd May 2015 at 2.30 p.m. in the Committee Room No. 05 of the Parliament of Sri Lanka, Sri Jayawardenepura Kotte to have a discussion on the ruling given by Mr. Speaker on 20th May, 2015 on the above issue. After deliberation a **Special Sub Committee to look into the Bond issues of the Central Bank -2015** had been appointed which consist of 13 members listed below to investigate into the controversial issue of Central Bank Treasury Bonds transaction took place on 27th February 2015.

Hon. DEW Gunasekara (Chairman)
Hon. (Dr.) Rajitha Senaratne
Hon. (Mrs.) Rosy Senanayake
Hon. Eran Wickramaratne
Hon. Sujeewa Senasinghe
Hon. Lasantha Alagiyawanna
Hon. Arjuna Ranatunga
Hon. A.D.Susil Premajayantha
Hon. Weerakumara Dissanayake
Hon. Sunil Handunnett
Hon. M.T. Hasen Ali
Hon. (Prof) Rajiva Wijesinghe
Hon. E. Saravananapavan

The **Special Sub Committee to look into the Bond issues of the Central Bank -2015** had a preliminary discussion on 22nd May 2015 at 3.00 p.m. on the Chairmanship of Hon. DEW Gunasekara and the future programme had been laid out. The Committee obtained the advice of Dr. W.A. Wijewardena (a former Deputy Governor of the Central Bank) who is an expert

in the field and Mr. Lionel Fernando, Attorney-at -Law, Legal Advisor to the Chairman, Hon. DEW Gunasekara. The deliberations had been conducted on 26th May 2015 onwards. The Committee had invited Dr. W.A. Wijewardena, former Deputy Governor of the Central Bank, and obtained certain clarifications and he had elucidated the Committee on the issue of Treasury Bonds of the Central Bank at the discussion held on 26th May 2015.

The following witnesses were summoned before the Committee during the period of 29th May, 2015 to 23rd June 2015 and oral evidences, documentary evidences as well as the audio evidences were examined.

Summoned Date	Name, Position and Institution
26.05.2015	Dr. R.H.S. Samarathunga the Secretary to the Treasury
	Dr. M.S.D. Ranasiri, Director General of Department of Treasury
29.05.2015	Mr. Ronald C. Perera, P.C., Chairman, Bank of Ceylon
	Mr. J.D.K. Dharmapala, Chief Dealer, Bank of Ceylon
	Mrs. U.L. Muthugala, Actg. Superintendent, Public Debt. Dept., CBSL
	Dr. M. Z.M. Azim, Addl. Superintendent, Public Debt. Dept., CBSL
03.06.2015	Mr. H.A. Karunaratne, Secretary to the Monetary Board and the Asst. Governor, CBSL
	Mr. R.A. Jayatissa, Members of the Monetary Board, Central Bank
	Mrs. Manohari Ramanathan, Members of the Monetary Board, CBSL
	Mr. D.M. Gunasekera, General Manager, Bank of Ceylon
	Mr. A.D.B. Talwatte, Country Managing Partner, Ernest & Young Company Ltd.
	Mr. H.M.A. Jayasinghe, Partner, Ernest & Young Company Ltd.
	Mrs. Y.A. de Silva, partner, Ernest & Young Company Ltd.
	Mr. W.W.D. Pradeep L. Perera, Senior Manager, Ernest & Young Company Ltd.
	Mr. P.G. Tissera, Former Asst. General Manager, Bank of Ceylon
04.06.2015	Mr. Aswin de Silva, Chairman, National Savings Bank
	Mr. S.D.N. Perera, CEO/General Manager, National Savings Bank
	Mr. P.A. Lionel, Head of Treasury, National Savings Bank
	Mr. D.L.P. Abeysinghe, Dealer, National Savings Bank
	Mrs. B.P.J. Gunasekara, Deputy General Manager/CEO, Fund Management Company
	Mr. Nihal Jayamanne, P.C., Chairman, Seylan Bank
	Mr. Somadasa Palihawadana, Chief Dealer, Seylan Bank
	Mr. N. Wasantha Kumar, General Manager, People's Bank
	Mr. Clive Fonseka, Head of Treasury, People's Bank
	Mr. R.A.A. Jayalath, Superintendent, Employees Provident Fund

	Mr. M.S.K. Dharmawardena, Addl. Superintendent, Employees Provident Fund
	Mr. J.D.S.J. Nanayakkara, Deputy Superintendent, Employees Provident Fund
	Mr. S. Pathumanapan, Asst. Superintendent, Employees Provident Fund
	Mr. Kasun Palisena, Chief Executive Officer, Perpetual Treasuries (Pvt) Ltd.
	Mr. Harin Nishantha, Marketing Manager, Perpetual Treasuries (Pvt) Ltd.
05.06.2015	Mr. B.D.W.A. Silva, Deputy Governor, CBSL
	Mr. P. Samarasiri, Deputy Governor, CBSL
09.06.2015	Mrs. C.M.D.N.K. Seneviratne, Superintendent, Public Debt Department, CBSL
	Dr. M. Z.M. Azim, Addl. Superintendent, Public Debt Dept., CBSL
10.06.2015	Mr. D.L.P. Abeysinghe, Executive Officer, Government Securities Dealing, National Savings Bank
10.06.2015	Mr. W.M.R.B. Weerakoon, Senior Manager (Dealings), NSB Fund Management Co. Ltd.
	Mr. Kavinda Mewan Gunawardena, Senior Trader Rates, HSBC
	Mr. D.N.R. Siriwardena, Registrar General of Companies
11.06.2015	Mr. Ajith Nivard Cabral, Former Governor, CBSL
17.06.2015	Mr. J.K.D. Dharmapala, Former Chief Dealer, Bank of Ceylon
	Mr. N.K. Dahanayake, CEO, NSB Fund Management Co. Ltd.
	Mr. N.W.G.R.D. Nanayakkara, Director, Financial Sector Research, CBSL
	Mrs. I.S. Fernando, Manager, Public Debt Department, CBSL
	Dr. P.N. Weerasinghe, Deputy Governor, CBSL
	Mr. D.N.R. Siriwardena, Registrar General of Companies
	Mr. Arjun Joseph Aloysius, Director, Free Lanka Trading Co. Pvt. Ltd.,
18.06.2015	Mr. Arjuna Mahendran, Governor, CBSL
	Mrs. M.S.M.P. Fernando, Senior Manager, Public Debt Department, Central Bank of Sri Lanka
23.06.2015	Mr. Arjuna Mahendran, Governor, CBSL

On 27 February 2015 the Central Bank of Sri Lanka issued Treasury Bonds to the value of Rs. 10,058 million (Rs. 10,058 B.) to fulfill the fund requirements of the General Treasury for the day, 2 March 2015, pursuant to the advertisements published in the Central Bank of Sri Lanka website and in the national newspapers of 26 February 2015. The following observations were made during the examination of the documentary evidence as well as personal representations made relating to the said Treasury Bond issue.

01. The Central Bank of Sri Lanka has the exclusive responsibility of issuing Treasury Bonds to fulfil the Government's monthly debt requirement submitted by the General Treasury. The Central Bank of Sri Lanka follows two methodologies in the process. One method is the primary auction. i.e. to invite the registered Primary Dealers to submit the bids for Treasury Bonds by way of advertisements thereof. The second

method is the direct/private placement method, i.e. accepting funds from primary dealers at the weighted average yield rate. There are two ways of determining the weighted average interest rate. One is the rate determined, based on the bid price put forward by the primary dealers in the previous auction. Other method is the interest rate computed based on the interest rate that prevailed in the secondary market. The direct placement is open on every working day and the willing Primary Dealers can obtain bonds at the pre-determined rates tenure.

02. Treasury bonds are complex market instruments and, therefore, needs further elaboration to understand how they work. They are issued at a fixed interest rate known as the coupon rate with maturities longer than 1 year. The government is obliged to pay interest semi-annually at the coupon rate on the face value of the bonds. Bonds are quoted by PDs at bond auctions at different prices, that is, above the face value, at the face value or below the face value. If they are quoted above the face value, the interest yield on the bond is below the coupon rate, at the face value, equal to the coupon rate, and below the face value, above the coupon rate. Thus, any interest yield above the coupon rate indicates that the bond in question is issued at a discount, equal to the coupon rate at the same value as the face value and below the coupon rate, at a premium over the face value. Thus, bonds issued at a yield rate lower than the coupon rate bring an additional profit to the government in the form of a premium income; in the opposite, bonds issued at yield rates above the coupon rate involve a loss in the form of a discount offered to the buyers of the bonds.
03. It is known that ordinary investors have a demand only for short maturity bonds, namely, bonds maturing between 2 years and 10 years. Bonds maturing longer than 10 years, that is, 15, 20, and 30 years, are principally demanded by insurance companies, provident funds and pension funds to build an appropriate portfolio composition. Hence, longer maturity bonds are issued with the objective of satisfying the demand from such institutions and establishing a yield curve (a curve depicting the yield of bonds to their maturity) to provide market information to investors.
04. The procedure adopted up to 27 February 2015 had been to get a minor portion of the Government's monthly debt requirement from the primary auction and to get the rest by the direct placement method. The composition of the monthly cash requirement as fulfilled through these two methods for the period January 2014 to May 2015 is as follows.

Month	Amount issued method			As percentage of Total Amount Issued	
	Auction Rs.Mn	Direct Placement Rs.Mn	Total Rs.Mn	Auction Method	Direct Placement Method
Jan-14	5,500.00	32,717.68	38,217.68	14	86
Feb-14	3,050.00	80,088.40	83,138.40	4	96
Mar-14	5,000.00	130,116.38	135,116.38	4	96
Apr-14		120,372.96	120,372.96	0	100
May-14	5,950.00	62,744.88	68,694.88	9	91
Jun-14		126,209.70	126,209.70	0	100
Jul-14	5,300.00	109,483.33	114,783.33	5	95
Aug-14		44,200.00	44,200.00	0	100
Sep-14	2,950.00	72,457.87	75,407.87	4	96
Oct-14		22,617.11	22,617.11	0	100
Nov-14		13,787.86	13,787.86	0	100
Dec-14	4,000.00	18,147.75	22,147.75	18	82
Jan-15		69,923.21	69,923.21	0	100
Feb-15	10,058.00	23,524.46	33,582.46	30	70
Mar-15	171,659.00	14,143.55	185,802.55	92	8
Apr-15	44,306.00		44,306.00	100	0
May-15	35,730.00		35,730.00	100	0
Total	293,503.00	940,535.14	1,234,038.14	24	76

The Committee further observed on certain occasions Treasury bonds had been issued solely through direct placement methods without using the auction method at all. Similarly, there were instances when the needed cash was raised solely by resorting to the

auction method. However, in the majority of cases, it was a combination of both that had been used and in all those instances, the share of the bonds issued by following the direct placement method exceeded 80% of the total issue.

05. Monetary Board had commenced issuing Treasury Bonds through the auction and through primary dealers in March 1997 in terms of the Board approval. MB/PD/05/18/97. It had also commenced to arrange for the subscription by Employees Provident Fund of any shortfall in any issue of Treasury Bonds in the same period.

Further, according to Monetary Board Paper No. MB/PD/1/26/2008 in the year 2008, the Monetary Board being concerned about the unwarranted increase in the interest rate on Government Securities, had approved the commencement of mobilization of funds through direct placement. It had also recommenced issuing Treasury Bonds to Employees Provident Fund and other captive sources at an interest rate five basis points above the secondary market rates through private placements to improve the market liquidity in terms of Board Paper No. MB/PD/25/20/2008.

The Committee also observed that the Guidelines of the Public Debt Department of the Central Bank clearly states that

"the Front Office has to make arrangements to meet financing needs as much as possible through auctions. The balance fund requirements of the Government as indicated in the approved borrowing programme may be arranged through private placements with PDs."

"After closing each T-bill and T-bond auction the Front Office prepares following documents and provides them to Treasury Bill/Bond Tender Board Committee which is appointed to take decisions on the amount to be accepted that gives the lowest and optimal cost and risk combination."

06. The Government fund requirement as at 02 March 2015 amounted to Rs. 13,550 million (Rs. 13,55 B.) according to the Cash flow Statement of March 2015 which was annexed to the letter No. TO/DG/CFS/03 dated 20 February, 2015 of the Director General of the Department of Treasury Operations addressed to the Superintendent of Public Debt Department of the Central Bank. At their meeting dated 27 February, 2015 the Domestic Debt Management Committee (DDMC) which in the committee responsible for managing the domestic public debt with a view to minimizing the cost and risk of government public debt comprising 05 members of the Central Bank and the Ministry of Finance recommended to raise Rs. 1000 million by primary auction and to raise Rs. 12,550 million by Direct Placement method together to satisfy the said fund requirement of the Government. Subsequently the approval of the Governor of the Central Bank of Sri Lanka was obtained for the said recommendation on 2 March, 2015.

07. By advertisements published on 26 February, 2015 on the Treasury Bonds issue by Primary Auction, bids were called from 16 registered primary dealers for the bonds to the value of Rs. 1000 million at 12.5 per cent Coupon Rate which will mature after a 30 year period. Acceptance of the bids were closed at 1110 hours though the normal closing time is 1100 hours on 27 February, 2015. From the examination of the records and the representations made it was observed that the bids have been received for Rs. 20,708 million (Rs. 20.708 B.) from the Employees' Provident Fund and 16 other Primary Dealers. (Annexe 1)
08. The Treasury Bond Tender Committee meeting No. 2/2015, convened between 12 30 hours to 13 10 hours on 27 February, 2015 decided to increase the amount of the Primary Bond auction by ten times to Rs. 10,058 million (Rs. 10.058 B.) instead of the Rs. 1000 million (Rs. 1 B.) recommended by the Domestic Debt Management Committee. This is a deviation from the decision already taken by the Domestic Debt Management Committee to issue Rs. 12,550 million through the Direct Placement method. Accordingly at the auction Rs. 10,058 million was raised by issuing 30 year Treasury Bonds on 9.3510 to 11.7270 weighted average yield rate (WAYR) from 14 Primary Dealers who submitted bids at the auction. (Annexe 2) The said decision was conveyed to the Public Debt Department verbally by the Senior Management of the Central Bank of Sri Lanka. The recommendation of the Treasury Bond Tender Committee and a Minute of the Superintendent of the Public Debt Department only available. The Public Debt Department has recommended to raise Rs. 2,608 million (Rs. 2.608 B.) as the best alternative having analyzed different options to the said 30 year Treasury Bond. But at the end of the said document there is a Minute by the Superintendent of Public Debt Department which was addressed to the Head of Front Office stating that "Governor instructed to raise funds up to Rs. 10 Billion taking into consideration additional fund requirement of the Government".
- The approval of the Domestic Debt Management Committee for the Debt Department borrowing programme for March 2015, also containing the details of the auction held on 27 February, 2015 at 1110 hours had been obtained at the meeting of the Domestic Debt Management Committee held at 15 00 hours the same day. The Governor of the Central Bank approved the Debt Borrowing Programme only on 2 March, 2015 by placing a minute that the bonds be issued under the established rates to Employees Provident Fund, NSB Fund Management Company Ltd. and the Sri Lanka Insurance Corporation. By the aforesaid approval it is evident that the Governor of the Central Bank of Sri Lanka has given approval to go for Direct Placement method in the award of Treasury Bonds for March 2015 as well. There was no indication of the discontinuance of the Direct Placement method in the aforesaid approval of the Governor.
09. The Committee further observed that the total fund requirement of the Government for the month of March was Rs. 261.683 billion according to the Domestic Borrowing Programme which was recommended by the DDMC on 27 February, 2015.

According to programme-the total fund requirement is fulfilled by issuing Rs. 89.683 billion of Treasury bills and Rs. 172 Billion by issuing Treasury bonds. It further amplified the issue of Rs. 1 Billion by primary auction and the balance through direct placements (Institutional/market sources)

The Governor of the CBSL has approved this programme by placing a Minute on 2 March, 2015 (the first working day of March) is as follows.

- “1. Raise Rs. 40 bn through issue of 20, 30, 50 years of T.Bonds, 10 bn each
- 2. EPF/NSB/SLIC to be asked to stabilize rates.”

This approval was conveyed to the Superintendent of Public Debt through Deputy Governor (SM). However, the Committee observed that this has not been implemented, as approved. Actual funds received during the month of March amounted Rs. 185,802 million out of which only Rs. 14,143 million was through direct placements. Therefore it is observed that this action was a deviation from the direction made by the Governor.

The personal representations made before the Committee proved that the Governor had visited the Public Debt Department of the Central Bank in two instances on 27th February 2015 where the Auction in question had taken place which had never happened before. First he had visited the Department around 10 45 hours while the bidding process was going on and remained up to the time of closing the Auction. Thereafter he had left and returned with two Deputy Governors namely Mr. B.D.W.A. De Silva and Dr. P.N. Weerasinghe at 12 30 hours after the bid had been closed. At that time the Governor had looked at the list of all bidders (Auction sheet- Annex) and had initially informed the officials to accept all bids amounting to Rs. 20.708 billion. However, Dr. M.Z.M. Azim, Additional Superintendent of Public Debt and Mrs. C.M.D.N.K. Seneviratne, Superintendent of the Public Debt Department had not agreed with that decision and were able to convince the Governor that it was not a proper decision considering the volume and the too high rates then the Governor had instructed them to raise funds by Rs. 10 billion from the auction and to convey that message to the Tender Board. Finally the officials had agreed upon the decision since the Governor had also stated that he would not allow Direct/Private Placements.

10. If this procedure was not followed and the Treasury Bonds were issued according to the approval given previously to raise Rs. 1000 million (Rs. 1 B.) it could have been possible to award the bids to the first 07 bidders set out below on 10.4652 maximum weighted average yield rate to raise the said amount by categorizing the bids received at the auction according to the lowest to the highest weighted average yield rate.

	Dealer	Amount Tendered (Rs.)	WAYRNT
1	BOC	8,000,000	9.3510
2	Acuity Securities Ltd	50,000,000	9.9063
3	First Capital Treasuries Ltd	100,000,000	10.0278
4	BOC	500,000,000	10.1970
5	Entrust Securities PLC	50,000,000	10.2339
6	NSB Fund MGT Com	100,000,000	10.2959
7	EPP	500,000,000	10.4652
		1,308,000,000	

It was observed during the examination by the Committee that if the Treasury Bond issue by Primary Auction was restricted to Rs. 1000 million (Rs. 1 B.) as aforesaid the bidders who were not included in the above 07 categories and placed No. 8 to 26 would not have been able to invest on the Treasury Bonds. Further it was observed that Perpetual Treasuries who was placed in No. 16, 17, 20 and 21 positions and the bids placed through the BOC in the place of 26 would not have been able to invest on the Treasury Bonds as well. Similarly Perpetual Treasuries has placed bids for 75 per cent (Rs. 2 Billion directly and Rs. 1.3 Billion indirectly through the Bank of Ceylon) out of the total bids received amounting to Rs. 20,708 million (Rs. 20.708 B.). Rs. 5 Billion was awarded to the Perpetual Treasuries out of the total bids placed by them which is approximately fifty per cent.

11. The Committee also observed that after calling for bids for Rs. 1,000 million (Rs. 1 B.) on the Primary Auction method by the advertisements published on 25 and 26 February 2015 and once the primary dealers forwarded their bids the said amount was increased by Rs. 9,058 million. A policy decision has been taken to cancel the earlier decision to raise Rs. 12,550 million (Rs. 12.5 B.) by direct placement method approved by the Domestic debt management programme relevant to March 2015 and to raise the said amount also from the Primary auction method. Although the Treasury Bond Tender Committee sent their observations, by the time acceptance of the bids were closed at 1100 hours (approximately 1110 hours) on 27.02.2015 the Monetary Board of the Central bank of Sri Lanka has not approved the said variation of the Treasury Bond issue. The Monetary Board Paper No. MB/ER/5/3/2015 dated 06.03.2015 discloses that they were informed by the Governor of the Central Bank of Sri Lanka of the temporary suspension of the direct placement method used to issue Treasury Bonds. The said decision conveyed to the Monetary Board was ratified by them subsequently. The Minutes of the Board on 23 February, 2015 shows that the Monetary Board had instructed the Public Debt Department to go for a 30 year Bond auction during the week and there was no decision taken to deviate from direct placement to primary auction method.

12. If this Treasury Bond was issued the way it was advertised i.e. Rs. 1000 million (Rs. 1 B.) worth Treasury Bonds were issued by Primary Auction in those circumstances the bids could have been accepted at 10.4652 weighted average yield rate when the bid price was at Rs. 104.50730 level. At that stage it would have been quite possible to stop issuing Bonds under Primary Auction and issue the rest of the Treasury Bonds following the Direct Placement system by informing the Primary Dealers to bid for Treasury Bonds at 10.4652 weighted average yield rate. If the latter system was followed it could have prevented the increase of weighted average yield rate up to 11.7270 and to decrease the bid price up to 90.16990.
13. Therefore, it is observed that from the two methods followed by CBSL in the issue of Treasury bonds for a while, the use of the direct placement method was suddenly stopped at the time the Tender Committee decision was taken. This was done after the bids were called and accepted for the issue of Treasury bonds on 27.02.2015. As a consequence of this decision, the weighted average yield rate net of tax was increased to 11.7270 in the financial market from the manageable level of 10.4652 which was the weighted average yield rate net of tax at the point of Rs.1,000 million (Rs. 1 B.) and the Government of Sri Lanka would have been able to avoid an opportunity cost and a commitment to the Government of 526 million in the form of paying a discount to investors which was not necessary. According to the data published by CBSL in its Weekly Economic Indicators as at 27th February 2015, investors had been willing to buy a 30 year bond maturing in 2044 in the secondary market at a premium price of Rs 131.02 corresponding to the yield rate of 10.16% (Table 3.6). Hence, the view of CBSL officials that there was a risk of being unable to raise all the money by resorting to direct placement method is not substantiated by market evidence. However, there is no evidence that Direct Placement method had failed to generate the required funds at any time previously. Certainly, it would not be the case when the market had been flooded with an excess liquidity of Rs 287 billion as per the data released by CBSL in the same Weekly Economic Indicators (page 6). Further, it was revealed that no financial impact assessment had been done by CBSL before it chose to discontinue the Direct Placement method and completely go for the Primary Auction method when issuing Treasury bonds thereafter. It appears to be a decision taken without proper study or evaluation.
14. On the other hand it was also observed during the Committee's examination that in the Direct Placement system of awarding the Treasury Bonds is done by direct land line communication to the Primary Dealers and thus there is no clear documentation in this system as in placing the bids competitively. Any way the rates offered by the CBSL are not much competitive. Therefore, there is no huge competition among the primary dealers for the available bids. Although the Central Bank of Sri Lanka was able to minimize the costs during this process of raising funds by way of Direct Placement method there are no available records pertaining to any rejection of the funds so demanded in the department other than the records available to the issuance of Treasury Bonds to fulfil the necessary fund requirement. There was no such

evidence of complaints received regarding not receiving the bonds through direct placement.

15. The committee observed the particular decision of the tender board of which any person could easily read the bid pattern which had leaked to the media and was widely available. This is a confidential document to be kept in the central bank of Sri Lanka which has signatures of the members of the tender board. This was identified as serious internal controls lapse of the Central Bank and recommended to hold an immediate internal inquiry by the Central Bank.
16. After 27 February 2015 all the Treasury Bonds issued up to now has been through the Primary Auction method and the following factors were observed in this regard.
 - (a) Even though Perpetual Treasuries Limited has submitted bids for the treasury bonds previously the said bids have not been accepted in significant amounts prior to 27.02.2015. But after this date majority of the bids placed by this institution was a success.
 - (b) The bids received in certain issues of the Treasury Bonds were for discounted price from the first bid onwards. In these circumstances also the Central Bank of Sri Lanka has accepted the bids placed by primary dealers for the entire fund requirement. Committee observed during the examination that the Central Bank of Sri Lanka has incurred an opportunity cost and commitment to the Government from the first bid so awarded.
17. The Committee further observed that due to the decision taken by the Governor of the Central Bank to deviate from the previous practice (accepting a lower amount at acceptable interest rates and offer the balance to primary dealers at the weighted average rate of the issue which was below the cutoff rate) and solely follow the primary auction method, has resulted the following consequences.
 - (a) In instances after 27 February 2015 the primary dealers have offered a discounted price from the inception of the bidding. The Central Bank has accepted those bids until they fulfilled their cash requirement.
 - (b) The Central Bank an opportunity cost and a commitment to Government of Rs. 526 million due to the acceptance of the bids which was submitted by the primary dealers below the par value at a higher yield interest rate to fulfill their monetary requirement.
 - (c) Certain auctions had been entirely rejected by the Central Bank because of the high interest rates of the bids received. Thus it demonstrates that the primary dealers have submitted bids at a level higher than the central bank acceptable rate.

- (d) A clear behavioral change of the primary dealers was observed after 27 February 2015. The private sector primary dealers effectively contributed to the primary auctions after the said decision is one such example.
- (e) This decision had led to the increase of the entire interest rate structure of all bonds, which is depicted in the yield curves attached herewith.
- (f) The accepted bidder out of the total bids received bought bonds at lower prices and sold the same at higher prices in the secondary market thereby making immediate profits. This also led to fluctuations in the rate of interest in the market and it created an unstable situation. This deviates the Central Bank objective of economic and price stability and financial system stability.
- (g) The aforesaid decision was unexpected and it surprised the market and substantiated by the following statements.

Bank of Ceylon

The BOC Primary Dealer who submitted bids on behalf of the Perpetual Treasury Ltd had also made their bids under a higher yield interest rate knowing well that their bid could not be accepted with their past experiences.

NSB Fund Management

The officials of the NSB Fund Management Company stated that they were not known to situation of raising huge amount of Rs. 10 billion by the Central Bank before this incident and their understanding was that this bid had been offered with the intention of establishing rates. At the Auction they had offered 03 Bids each of Rs.100 million on behalf of the NSB. The amounts and rates to be offered had been decided by the Fund Management Committee/Board based on market conditions.

According to their observations market rates for a 30 year Bond at the time of auction was around 9.35 %. As a result of higher rate of 11.73 % established through the Auction, market rate gone up immediately creating a market threat. Hence they had to incur a loss of Rs. 160 million revaluation loss immediately after the Auction. Further they mentioned that they had to face difficulties in valuing at rising rates even though they have got sufficient portfolio. (Annexe: NSB Fund Management Monthly Financial Statements)

Hongkong and Shanghai Banking Corporation

Mr. Kavinda Mewan Gunawardena, Senior Trader Rates, of the HSBC mentioned that he had just placed a bid worth Rs. 100 million in order to meet the minimum requirement of 10% with the thought of that the CBSL would not accept as he was not aware that the Government was in need of huge amount of money. He had send an e-

mail to one of his friend on that day which shows the market conditions prevailed at the date of auction according to his understanding.(Annexe No:) He was able to make a profit by selling it out on the same day and otherwise he would not be able to make a profit as rates had gone up.

Contrary to the above statements the Perpetual Treasuries Ltd. had made the following explanation.

Seylan Bank

Mr. Somadasa Palihawadana, Chief Dealer of the Seylan Bank had mentioned that he could hardly remember such instances whether there had been any previous experiences where the total amount accepted had increased by several fold in comparison to the amount advertised, with regard to long term bonds. According to Mr. Palihawadana, although the particular bond had been once traded in the market at 9.67%, the Seylan Bank had not wanted to purchase it at such a lower rate due to the risk associated with a long term bond. It was further stated that the Seylan Bank had received bonds in most of the occasions they had applied for.

Commenting on the gain and the risk for the Bank of Ceylon which purchased Rs.3 billion bonds in this bond issuance on behalf Perpetual Treasuries (Pvt) Ltd., Mr. Palihawadana stated that the BOC should have make a higher yield out of this as the rate for call money in the market had been around 6% at that time. However, according to Mr. Palihawadana, there is a price risk for the bank in the event the customer does not settle the outstanding. He also stated that his bank might not take such a risk on behalf of a customer in relation to a 30 year bond.

People's Bank

Mr. Clive Fonseka, Head of Treasury of the People's Bank informed the Committee they only bid for Rs.100 million as per the statutory requirement since they did not want to have this 30 year bond in their portfolio. When enquired whether the Chief dealer of the Bank, has the discretion to take a decision at the dealing room in case he got a call from a long standing customer to bid for him. Mr. Fonseka stated that it should be approved by the Investment Committee which is in the dealing room itself. He also stated that a decision in such an instance could be made within the limits approved by the bank. However, the approval will be given for such a request by the Investment Committee only if they are satisfied with the funding arrangement of the customer.

Employees Provident Fund (EPF)

Mr.S. Pathumanapan, Asst. Superintendent of EPF, stated that reaching the total issued amount to Rs.10 billion was not a surprising matter, when the nature of the industry was concerned. According to Mr. S. Pathumanapan, in the first quarter of the year, the interest rates are naturally high and so is the requirement of the Government as the allocated funds had already been utilized fully.

Perpetual Treasuries Ltd.

CEO of the Perpetual Treasuries Ltd. Mr.Kasun Palisena stated that they had once had a portfolio of Rs.11.7 billion in the secondary market and further mentioned that no bid as high as in this case under question had ever been made before. He further stated that the capital adequacy required to make higher bids had been achieved only in November, 2014. It was mentioned that he materialized the bond by analyzing the requirement of the Central Bank in terms of the debt maturities, coupon payments, sovereign, IMF Dollar payments etc. using the information available in its web site. Since no auction had taken place during the period from November to February, Mr.Palisena stated that he guessed that the amount to be issued should be larger. Mr. Arjun Joseph Aloysius, Director, Free Lanka Trading Co. Pvt. Ltd., who was a former Director of the Perpetual Treasuries Ltd. further confirming above facts stated that the staff of that company had shown high performances and as such were able to bid in such a way that they could obtain huge amount at the auction. He also stated that the Company had, strong assets to liability ratio, market volatility, etc. Moreover, participation details of the Perpetual Treasuries Ltd. In CBSL Treasury Bonds as a Primary Dealer shows extraordinary performances after 27th February 2015. The maximum amount of the Bid offered by them before that is Rs. 250 million. And only Rs.27 million from the bid offered to the value of Rs.150 million had been accepted during the period of 26.02.2014 – 30.12.2014. Further from 10th March 2015 onwards they have offered bids ranging from Rs. 300 million to Rs. 3000 million and received bids in the range of Rs. 50 million to Rs. 3000 million. (Annexure No: 16).(Even though Perpetual Treasuries Limited has submitted bids for the treasury bonds previously the said bids have not been accepted in significant amounts prior to 27.02.2015. But after this date majority of the bids placed by this institution have been accepted.)

18. The Central Bank received the General Treasury cash flow requirement on 20 February 2015. There was a monetary requirement on 02 March 2015 to settle a Government loan installment. It was observed that the Central Bank had enough time to obtain the necessary fund requirement.

It was observed that in an emergency the Central Bank of Sri Lanka had the following alternative methods to obtain the necessary funds without giving an opportunity to fluctuate the market interest rates.

- Obtain an overdraft facility through a Government bank
- Issue short term Treasury Bonds
- Obtain funds through captive sources

19. The main objective of the Central Bank of Sri Lanka is to stabilize the money market. The decision taken on 27 February, 2015 was dependent upon the supply and demand behavior of the market caused by creating an uncertainty offering prospects for

participants and the causing of upward movement in the interest rate structure followed rate volatility.

20. Perpetual Treasuries Ltd (PV 88550) is a fully owned subsidiary of Perpetual Capital (Pvt) Ltd. Geoffrey Joseph Aloysius and Arjun Joseph Aloysius are the shareholders of Perpetual Capital (Pvt) Ltd. They have equal shares of the company. Mr. Arjun Joseph Aloysius was a Director of Perpetual Treasuries Ltd. and he has resigned from the said post on 16th January 2015. The aforesaid Director of Perpetual Capital (Pvt) Ltd Mr.Arjun Joseph Aloysius is the son-in-law of the Governor of the Central Bank of Sri Lanka. Since the Perpetual Treasuries Ltd. is a fully owned subsidiary of Perpetual Capital (Pvt) Ltd. the interest with the Perpetual Treasuries Ltd. with Mr. Arjun Aloysius cannot be ruled out. Thereby it is evident that the Primary Dealer Perpetual Treasuries Limited and the Central Bank had a related party transaction.

Ms. Shiromi Noel Wickremasinghe was appointed as a director of Perpetual Treasuries (Pvt) Ltd on 23 December 2013. She continued as a Director of Perpetual Treasuries (Pvt) Ltd till 09 March 2015. She is a sister of the former Governor of the Central Bank. Therefore it was observed that there could have been related party transactions in between the Central Bank of Sri Lanka and Perpetual Treasuries (Pvt) Ltd at that time also.

21. The Committee observed that the behavior of Perpetual Treasuries Ltd with regard to this particular bond issue and soon before and after the bond issue and noticed a suspicious behavior due to following reason.
 - a) The Company had the Capital of Rs. 1,020.84 Million and according to the Public Debt Department Circular No. 08/24/002/0005/006 dated 22 June, 2006, it can only bid up to 12.5 times of the Capital, and that amounted to Rs. 12,760.60 approximately as at 27 February, 2015 and it had bid for Rs. 15,000 million or 14.9 times the limit.
 - b) This is the first time that a primary dealer had bid through another primary dealer.
 - c) The Company had asked Bank of Ceylon to bid on behalf of them at the last few minutes of the auction time. (That is around 1048 hours). Bank of Ceylon had requested an extension of 10 minutes from CBSL indicating that there are large bids on their hands. Central Bank of Sri Lanka as well had granted the extension even though the extensions are given only for valid reasons such as technical defaults of the system. This last moment transaction limits the decision making abilities of Bank of Ceylon.

- d) The participation of the Perpetual Treasuries Ltd. for the Treasury bonds and the acceptance and the rejection are given in the following Table.
- e) The Perpetual Treasuries had entered into SWAP agreement with the Bank of Ceylon to settle the bonds obtained through Bank of Ceylon. Further that the Company have sold a considerable amount of Treasury Bills and Treasury Bonds on the subjected auction date of 27 February 2015 to fund the aforesaid transaction. This proves that they have entered into this transaction without sufficient funds in their hand.
- f) Seventy five per cent of the total bids received were come from the Perpetual Treasuries Limited and fifty per cent of the awarded bonds were obtained by Perpetual Treasuries Limited.

22. Bank of Ceylon

- a) Details of bids submitted by the Bank of Ceylon, Primary Dealers unit at 30 year Treasury Bond auction held on 27 February 2015 are depicted below.

	Customer	Rate	Face Value (Rs. Million)	Offer Amount (Rs. Million)
1.	Kaluthara Bodhi Trust	9.35%	8	8
2.	Ceylineco Insurance Life	10.25%	500	500
3.	Perpetual Treasuries Ltd	12.50%	3,000	3,000
4.	Perpetual Treasuries Ltd	12.75%	5,000	Unsuccessful
5.	Perpetual Treasuries Ltd	13.00%	5,000	Unsuccessful
Total			13,508	

- b) Bank of Ceylon has been requested to submit a bid for and on behalf of another Primary Dealer at a Treasury Bond auction for the first time. i.e. Treasury Bond auction held on 27 February 2015 and bidding for and on behalf of Perpetual Treasuries Ltd.
- c) Bank of Ceylon Treasury Division does not obtain Know Your Customer (KYC) forms from reputed Banks and Primary Dealers separately.
- d) Funding Arrangement

According to Section No. 6 of Bank of Ceylon Treasury Operations Manual, Primary Dealer Unit should not process applications without verification of funds,

signatures and other vital data. They also should adhere to the K.Y.C. guidelines especially in cash transactions. Though the Primary Dealer Unit was aware that the Perpetual Treasuries Ltd. did not have sufficient funds to settle the Bids in the event of success, the Bank of Ceylon as a Primary Dealer, had agreed to act on behalf of another Primary Dealer.

- e) The second transaction was a SWAP Transaction where Bank of Ceylon has bought Rs. 2.3 Billion worth of Bonds from Perpetual Treasuries on 2 March 2015 and sold the same Bond on 6 March 2015 at the rates of 12.50 percent and 12.4950 percent respectively. The Committee further observed that Perpetual Treasuries has first settled Rs. 1 Billion worth of Bonds at 1526 hours on 2 March 2015. According to the Central Bank, Perpetual Treasuries has received another Rs. 2 Billion worth of Bonds from the auction. Therefore, they have had sufficient securities to settle the Rs. 2.3 Billion transaction agreed on the SWAP basis. (to sell the Bond to Bank of Ceylon). Thereafter they have settled the outstanding Rs. 2 Billion (purchased from Bank of Ceylon through auction) to Bank of Ceylon on the same day.

The SWAP agreement is attached herewith (Annex No). The Chief Dealer, Bank of Ceylon had entered into SWAP transactions. The Committee observed that the Chief Dealer had violated the regulations of the Board Approved Delegated Authority limits applicable to secondary market transactions as stipulated in the Board Memorandum dated 28 September, 2012. The Committee further observed that, according to Deal Summaries of 2 March, 2015 this SWAP transaction has later been approved by the Chief Manager and Assistant General Manager of the Bank of Ceylon Treasury Division. (Annex)

Subsequently, Perpetual Treasuries Ltd has repurchased the Rs. 2.3 Billion Bonds from Bank of Ceylon concluding the SWAP transaction. Bank of Ceylon has realized a gain of Rs. 3.9 million out of this transaction.

- f) There is no documentary evidence for the time extended up to 11.10 Hours for the Central Bank of Sri Lanka Bid Auction held on 27 February 2015. It has been agreed by telephone communication. According to the Central Bank bidding printout, the auction time has been extended until 1110 Hours (Annex)
- g) As stated by the Primary Dealer (Perpetual Treasuries Ltd.) had bid on behalf of Insurance Company. However, they could not provide documentary evidence in support to prove this statement. It was also evident that these Bonds purchased by the Perpetual Treasuries Ltd. have never been sold to Insurance Company in the secondary market.
- h) At present Bank of Ceylon has no written procedure for primary bidding on account of other Banks, major reputed Corporations and Primary Dealers. When submitting bids to auction on behalf of these parties, Bank of Ceylon consider their names (whether they

are reputed parties) and the practice adopted in the past. All the payments in respect of the deals agreed with such parties are generated from a Commercial Bank and routed through Central Bank (Scrip less Securities Settlement System).